



Global Credit Research

Rating Update

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Rating Update: [California \(State of\)](#)

MOODY'S UPGRADES CALIFORNIA TO A2, BASED ON CONTINUING STATE ECONOMIC RECOVERY AND IMPROVED FINANCIAL OUTLOOK

Rating outlook remains positive on \$45 billion of G.O. bonds and related debt

California (State of)
State
CA

Opinion

NEW YORK, Jul 11, 2005 -- Moody's Investors Service has upgraded the State of California's general obligation bonds to A2 from A3, while maintaining the state's positive rating outlook. The upgrade reflects a continuing favorable trend of recovery in the state's economy and tax revenues, better than expected financial performance in fiscal 2005, and a moderately improved financial outlook for 2006 and beyond. California's rating still remains low compared to other states, due to its ongoing fiscal challenges. However, continuation of current trends is expected, and reflected in the positive rating outlook.

Today's rating action affects some \$36.5 billion of outstanding state G.O. bonds, \$5.7 billion of General Fund-supported lease revenue bonds, and \$2.5 billion of General Fund-enhanced tobacco settlement bonds. The state also has \$10.9 billion of outstanding Economic Recovery Bonds, which constitute state general obligations but are rated Aa3/stable (unchanged) based on additional security provided by a pledge of certain state sales tax revenues. The current rating action takes into account the large increase in long-term state debt that has occurred over recent years, which results in an above-average level of indebtedness relative to other states.

STATE ECONOMY EXPANDING AT MODERATE PACE

California's economy recorded a strengthening pace of economic recovery during 2004, as discussed in prior reports, and the state's favorable economic trend has continued in the first half of 2005. For example, payroll employment recorded average growth of about 1.7% in the first five months of the year (compared to the same period last year), even as the government sector (about 15% of total jobs) has remained relatively flat. In terms of personal income, the state recorded estimated growth of 7% in the first quarter of the year, following growth of about 6% during all of 2004. California's income growth and private sector job growth have recently been running above the U.S. average. While there are significant regional differences in the pace of growth, most areas of the state including the San Francisco Bay Area are now seeing at least a moderate level of sustained recovery. The state's current forecast calls for employment growth continuing at 1.7% for the remainder of 2005, and full-year personal income growth of 5.7%, both of which are reasonable in light of recent trends.

FISCAL 2005 FINANCIAL PERFORMANCE EXCEEDS EXPECTATIONS

The state's favorable economic performance is also reflected in state tax revenues, which posted a second consecutive year of healthy growth in fiscal 2005. Personal income tax (PIT) receipts were up an estimated 15% for the year, significantly better than expected, while sales tax receipts were up 5.2%, approximately on target. On the PIT front, the state estimates that just over \$9 billion of receipts are related to capital gains and stock options, representing more than 20% of PIT collections and almost 12% of total General Fund tax revenues for the year. While this is a relatively high exposure to these historically volatile sources of income, it does remain far below the prior peak of almost \$18 billion received from such sources in fiscal 2001. Corporate tax receipts also surged several billion dollars beyond projections, though this mainly reflects a temporary acceleration of future year's payments in connection with administrative tax enforcement changes made by the state.

While there were several areas of negative budget variances in 2005 -- such as the inability to sell pension bonds (due to litigation), and the failure of a revenue initiative related to punitive damage awards - these were far outweighed by the surge in general tax revenues, while spending appears to have come in more or less on target for the year. As a result, the state's liquidity position at year end was significantly higher than expected, with an ending General Fund cash balance of close to \$4 billion and more than \$9 billion of available/borrowable cash in other state funds. In addition, there is \$3.7 billion of remaining recovery bond issuance capacity under last year's \$15 billion voter authorization, representing an added potential liquidity source, if needed. The authorization places no time limitation on the issuance of recovery bonds, although the Department of Finance is required to certify that any proceeds will be used to fund obligations deferred from prior years.

2006 BUDGET INCREASES GENERAL FUND SPENDING BY 10%. NO RECOVERY BOND ISSUANCE PLANNED, BUT STRUCTURAL IMBALANCE PERSISTS AT ABOUT 6% to 7% OF SPENDING

Based on preliminary information from the Department of Finance, the agreed state budget for fiscal 2006 calls for General Fund expenditures of about \$90 billion, an increase of more than 10% over estimated spending in 2005. Adjusting for a one-time \$1.2 billion loan repayment to local governments, the spending increase is just under 9%. The budget primarily increases spending on education, transportation programs, and Medicaid. Significantly, the increase in K-12 education spending, about \$2.3 billion from the General Fund, was held significantly below what it could have been under the usual spending formulas. Moderate cost savings measures were also agreed in various social service programs.

A noted feature of the budget is the absence of any planned issuance of recovery bonds, made possible by the recent surge in PIT and corporate tax revenues. As discussed above, the tax windfall has boosted the 2005 ending fund balance, which will be substantially drawn down to support spending in 2006. There are several other non-recurring budget solutions as well, including an assumed \$525 million issue of pension bonds, \$525 million of tobacco settlement bond refunding proceeds, and \$1.3 billion from the diversion of local government revenues (second and final year of this diversion). As a result, by Moody's estimate, the gap between recurring revenues and spending in 2006 is about \$5.6 billion, or 6% of spending for the year. This includes adjustments for the amount of estimated corporate tax payments attributable to 2006 that were accelerated into 2005 and for the one-time local government loan repayment in 2006.

An analysis by the LAO of this year's budget and, importantly, its implications for the state's structural budget imbalance going forward, has not yet been released. The Department of Finance preliminarily estimates next year's potential structural gap at about \$6.6 billion, before making any deposit to the Budget Stabilization Account. A deposit equal to 1% of General Fund revenues is contemplated by the terms of Proposition 58 passed by the voters last year (but subject to gubernatorial discretion). We note that the \$6.6 billion estimate is inflated somewhat by the corporate tax payment surge this year, some of which is likely attributable to payments that otherwise would have been received in 2007. On this basis, the structural imbalance appears to now be in the range of 6% to 7% of spending, compared to estimates of about 10% or higher at this time last year. Nonetheless, the structural imbalance situation still represents a significant ongoing fiscal challenge for California, and is a major reason for the still low bond rating relative to other states.

PROPOSED CONSTITUTIONAL AMENDMENTS ON NOVEMBER BALLOT

The Governor has called for a special election this November, and a host of voter initiatives have qualified to appear on the ballot. Foremost among these is Proposition 76 which proposes several amendments to the constitution concerning state finances and budgeting, including a cap on annual state spending growth, tying this to the last three years' average revenue growth. If approved, the new spending cap would supersede the constitution's existing K-14 spending mandate approved by voters in 1988 (i.e. Proposition 98) and make several other alterations to that mandate. Proposition 76 also includes new intra-year budget-cutting powers for the governor in the event that revenues under-perform and the legislature does not take action to respond within a specified timeframe (essentially restoring powers that were in effect prior to 1983). The measure would also provide for the continuation of the prior year's budget in any year when a new budget has not been approved, which it is hoped will be an incentive to avoid future budget delays, and make several other changes regarding the ability of the General Fund to borrow in future from special funds and the repayment of outstanding loans from such funds. As of this writing, the Governor supports Proposition 76, most legislators do not, and the measure trails in public opinion polls. Negotiations are reportedly underway between the governor and the legislature to possibly craft an alternative, jointly-supported measure.

Among the other measures qualifying for the November ballot are proposals to change the way legislative districts are drawn and extend the time required for public school teachers to receive tenure, both of which are supported by the Governor as of this writing. Another measure would significantly restrict the ability of public employee unions to spend union dues on political lobbying activities. In Moody's view, the likely outcome and effects of the November election are highly uncertain, but could be significant for the state's

future financial situation and political dynamics.

LONG-TERM DEBT BURDEN RISES, BUT REMAINS IN MODERATE RANGE

Based on large borrowings for both capital and deficit purposes, the state's net tax-supported debt has more than doubled in the past three years, and is now some \$56 billion. However, at about 4.5% of aggregate personal income (ranking twelfth highest among the states), the debt burden is not currently a credit concern. Scheduled annual General Fund debt service as a percent of General Fund revenue remains at about 5%, noting that this excludes debt service on recovery bonds and tobacco settlement bonds and the associated pledged sales tax and tobacco revenues. The debt service ratio inclusive of these is about 6.5%.

The state's principal pension plans are relatively well-funded, due in part to provisions of state law that ensure annual employer contributions in line with actuarial requirements (noting that some of the actuarial assumptions have recently been loosened by CALPERS). June 2004 funding ratios - i.e. actuarial value of assets to actuarially calculated liabilities -- for the CALPERS and CALSTRS plans are about 84% and 83%, respectively. The funding ratios based on market value of assets are slightly lower. The 2006 budget includes an assumed \$525 million bond issue to fund a portion of the state's 2006 CALPERS contribution. The bond issue is the subject of litigation as to its validity, and if the issue does not go ahead the state will need to make the full contribution from other budgetary sources.

Outlook

California's rating outlook remains positive, reflecting continued favorable trends in the state's economy and tax revenues. The pace of additional improvement in the state's G.O. bond rating could lag, or exceed, economic trends, depending on finance and budget-related developments over the next year and the associated outlook for regaining structural budget balance and maintaining good liquidity. Given the current economic trend, and the availability of unused ERB deficit financing capacity, we believe there is low likelihood of any serious new liquidity strain occurring over the next eighteen months.

What could change the rating - Up

* Continued budgetary improvement that narrows projected out-year budget gaps and maintains comfortable liquidity measures

What could change the rating -Down

* Significant liquidity deterioration, including return to issuance of short-term debt with refinancing risk

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